COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

D.T.E 03-40

BOSTON GAS COMPANY
d/b/a
KeySpan Energy Delivery New England

DIRECT TESTIMONY OF DAVID J. EFFRON

On behalf of

THE OFFICE OF THE ATTORNEY GENERAL

July 7, 2003

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, telephone, gas and water rate filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in rate case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in approximately two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, New Jersey, New

York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Office of the Attorney General.

Q. What is the purpose of your testimony?

A. Boston Gas Company, d/b/a KeySpan Energy Delivery New England, ("Boston Gas" or "the Company") has filed an application with the Department of Telecommunications and Energy ("Department" or "D.T.E.") for approval of its proposed performance based rate plan. In conjunction with that application, Boston Gas has requested increases in its gas distribution rates that would produce an additional $61.3 million in base rate revenues and approval of a reconciliation mechanism for pensions and postretirement benefits other than pensions ("PBOP") costs. In this testimony, I address certain elements of the Company's determination of its revenue deficiency. In particular, I address the Incremental Cost Adjustment included by Boston Gas in its cost of service, the pro forma pension expense, and the calculation of income taxes. I also address the Company's request to implement a Pension/PBOP Reconciliation Adjustment Clause.

III. INCREMENTAL COST ADJUSTMENT

Q. How do utility operating companies that are part of a holding company structure typically account for common or joint costs provided by a central service company?

A. In general, service companies like KeySpan Corporate Services LLC ("Service Company") assign or allocate joint and common costs to those companies to which the services are provided. The Securities and Exchange Commission requires that costs that cannot be directly assigned be allocated based on established cost allocation principles. It is my understanding that the Department also requires utilities under its jurisdiction to allocate costs based on established principles, whether those costs are being allocated to the utility from a service company, among utilities, or from the utility to non-utility businesses.

Q. Has the Company, in this case, followed such established allocation principles?

A. No. As described further below, Boston Gas Company has changed its accounting system and made adjustments to its cost of service to move the overhead costs which normally would be allocated to the Company's affiliates, Essex Gas Company ("Essex") and Colonial Gas Company ("Colonial") in such a way that the Company's pro forma cost of service limits Service Company allocations to Essex and Colonial to costs deemed to be incremental to the provision of service to each of those affiliates.

Q. What is the role of the Incremental Cost Adjustment in achieving the Company's desired allocation of Service Company costs to Boston Gas for ratemaking purposes?

A. As explained in Exhibit KEDNE/PJM-1, at pages 20-21, it is the Company's position that in its approval of the acquisition of Essex and Colonial by Eastern Enterprises, the Department specified that only incremental costs incurred by Boston Gas for service provided to Essex and Colonial would be assigned to those two companies for Boston Gas ratemaking purposes. With regard to Essex, the Boston Gas books of account already reflect the allocation of expenses to that company on what Boston Gas deems to be an incremental basis. Therefore, the Company made no further allocation to Essex.[1] However, with regard to Colonial, the Boston Gas books of account reflect an assignment of costs provided through the Service Company, including the allocation of non-incremental costs. Therefore, to reflect only what were deemed to be incremental costs incurred by Boston Gas for service provided to Colonial in Colonial expenses and to re-allocate all costs deemed to be non-incremental to Boston Gas, the Company proposed an "Incremental Cost Adjustment" to the test year cost of service. The Incremental Cost Adjustment increases pro forma test year expenses by $7,256,000, to adjust for costs that were allocated to Colonial on the actual books of account, but were deemed by the Company to be non-incremental costs.

Q. Has the Company explained how costs incremental to Colonial and Essex were identified?

A. Yes. The response to Information Request AG-11-1 describes how the Company determined which costs were incremental. The Company established three categories of costs:

1. Costs associated directly with a project activity directly assigned to Essex or Colonial. Such costs are incremental and not allocated to Boston Gas for ratemaking purposes.

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[1] In response to AG-11-1, the Company stated an additional $425,031 of incremental costs should have been assigned to Essex from the amount originally assigned. Boston Gas made this correction in an errata filing.

2. Costs that are related to activities such as field marketing, leak surveys, and meter operations. Such costs were deemed to be incremental and not allocated to Boston Gas for ratemaking purposes.
3. Administrative and general expenses including finance, human resources, legal and corporate management. To the extent such costs were not directly assignable, they were deemed to be non-incremental and allocated to Boston Gas for ratemaking purposes.

Q. Has the Company provided details of the Incremental Cost Adjustment?

A. Yes. Exhibit KEDNE/PJM-2, Supplemental Information, Pages 88-96 shows details of the Incremental Cost Adjustment. As described in the response to Information Request AG-11-1, to the extent Service Company administrative and general costs were not directly assignable to Colonial, they were deemed to be non-incremental and allocated to Boston Gas for ratemaking purposes in this case.

Q. Does this method of allocating the administrative costs to Boston Gas appear to be reasonable in all cases?

A. No. For example, the costs of the tax staff, which had been allocated in part to Colonial on the actual books of account, were re-allocated in their entirety to Boston Gas as part of the Incremental Cost Adjustment. While it is reasonable to expect that there would be economies of scale from integrating the tax staff functions of Boston Gas and Colonial, there would most likely still be some incremental tax staff costs attributable to Colonial. Similarly, activities such as internal audit and purchasing management were re-allocated in their entirety to Boston Gas for ratemaking purposes. Again, while it reasonable to expect that there would be some economies of scale in these areas, there would still likely be some expenses that are properly attributable to Colonial.

Q. Have you prepared an analysis of the reasonableness of the administrative and general ("A&G") expense, with the Incremental Cost Adjustment, included by Boston Gas in its revenue requirement in this case?

A. Yes. To assess the reasonableness of the A&G expense included by the Company in its test year revenue requirement, I compared the A&G incurred by the Company prior to the Essex and Colonial mergers to the pro forma A&G included by the Company in its revenue requirement in this case. I show the results of this analysis on Schedule DJE-1 accompanying this testimony.

Q. Please explain your Schedule DJE-1.

A. On Schedule DJE-1, Page1, I begin with the actual A&G expenses incurred by Boston Gas in 2002, as reflected in its books of account. For the purpose of my analysis, I have excluded two expense accounts that are included in actual A&G expense. First, I excluded Account 922 – Administrative and General Expense Transferred, which is a credit to the total A&G costs reflected as an expense. I have excluded this item because Boston Gas uses this account to record a credit for Production and Storage Costs and Gas Acquisition Costs that are recovered through the CGA, as explained by the Company in its response to Information Request AG-

1-57.[2] As this credit is not related to A&G expense actually incurred in 2002, I have removed this credit from the total of A&G expense for the purpose of my analysis.

Second, I excluded Account 926 – Employee Pension and Benefits from my analysis. Employee pensions and benefits include costs that are directly related to functional labor expense, but the uniform system of accounts specifies that pensions and benefits are to be included in A&G expenses. However, as these costs are for the most part, in substance, functional expenses, I have excluded them from my analysis.[3]

In 2002, total administrative and general expenses, excluding Accounts 922 and 926, as actually booked by the Company were $47,490,000. The Company has stated that certain modifications to those expenses are necessary to correct the expenses allocated to Boston Gas in 2002.

Q. What are those corrections?

A. As explained by the Company in its Errata Filing of June 25, 2003, the following corrections are necessary: a reduction of $425,000 for incremental costs that should have been allocated to Essex[4], an increase of $149,000 to exclude Midland Enterprises from the Service Company expenses allocator on a pro forma basis, a

[2] The uniform system of accounts states that Account 922 is to be used to credit costs charged to Account 920 – A&G Salaries and Account 921-Office Supplies and Expenses for the capitalization of those costs and the transfer of those costs to non-utility operations. Had the Company used account 922 for its designated purpose, elimination of this account from the analysis would not be necessary.

[3] To the extent pensions and benefits expense are affected by changes in assumptions used to calculate pension and PBOPs, rather than actual changes in the level of operating costs, such changes in assumptions could also distort the comparison in this analysis.

[4] This modification implicitly assumes that the full $425,000 is A&G expense.

reduction of $401,000 for the allocation of corporate governance costs to KeySpan Holding Company, and a reduction of $72,000 for SEC audit adjustments. After these modifications, the corrected A&G expenses (excluding Accounts 922 and 926) in 2002 are $46,741,000. This is the A&G expense before the Incremental Cost Adjustment.

Q. What is the effect of the Incremental Cost Adjustment?

A. The total Incremental Cost Adjustment is $7,256,000. Of this amount, adjustments to A&G expense accounts represent $6,880,000. Thus, after the Incremental Cost Adjustment, the pro forma A&G expense (excluding Accounts 922 and 926) is $53,621,000.

Q. How does this compare to the A&G expense incurred before the mergers of Essex and Colonial?

A. On Schedule DJE-1, Page 2, I show the A&G expense incurred by Boston Gas in the three years prior to the mergers, again excluding Accounts 922 and 926.[5] I have used three years to avoid the possible distortions that could result from the use of one year. It should be noted that including 1996 and 1997 increases the calculated A&G expense incurred prior to the merger.[6] In this regard use of the three-year average is more conservative than relying on 1998, the last year before the mergers,

[5] In 1996, there was a credit of $119,000 to Account 922. Including this in the analysis would not have a material effect.

[6] This is especially true with regard to Account 930 in 1997, which appears to be an outlier. To be conservative, Account 930 in 1997 was not adjusted for the purpose of this analysis.

alone. The average A&G expense for the three-year period prior to the mergers was $29,039,000.

I then escalated the average A&G expense for the three-year period 1996-1998 by 3% per year for five years. The purpose of applying this escalation factor was to account for inflation plus real system growth (as measured by the number of customers) from the three-year period prior to the mergers until 2002. I believe that this 3% escalation factor is a conservative[7] estimate of the combined effect of inflation and system growth on A&G expenses over this period. The escalated A&G expense from the three-year period prior to the mergers is $33,664,000.

Q. How does this compare to the pro forma test year A&G expense?

A. As stated above, the pro forma test year A&G expense, after the Incremental Cost Adjustment, is $53,621,000. This is approximately $20 million greater than the average annual escalated A&G expense from the three-year period prior to the mergers.

Q. Does this imply that there may be problems with the methods used by the Company to determine the non-incremental A&G expense that is allocable to Boston Gas for ratemaking purposes?

A. Yes. Although the fine points of how the non-incremental expenses can be attributed to Boston Gas can be argued, it should be beyond dispute that the mergers with Essex and Colonial should not cause an *increase* in the expenses

[7] Conservative in the sense that it results in a higher escalated expense level that would use of a lower escalation factor, which could well be justified.

incurred by Boston Gas. That is, while it is the Company's interpretation of the Department's findings in the orders approving the acquisition of Essex and Colonial by Eastern Enterprises that all savings from economies of scale should be assigned to Essex and Colonial, there is no reasonable argument that the mergers should cause the non-incremental A&G expenses incurred by Boston Gas to be higher.

If anything, it would be logical to expect the A&G expenses incurred by Boston Gas since the 1996-1998 time frame to have decreased. Exhibit KEDNE/JFB-1 states that as a result of the KeySpan merger with Eastern Enterprises, "the formation of a service company framework creates efficiencies of scale and scope that ultimately help to reduce the cost of service for all operating affiliates supported by the Service Company." (Page 20) To the extent such efficiencies of scale affect Boston Gas (and there is no indication that they do not) such reductions to the cost of service should inure to the benefit of customers, as, to my knowledge, the Department has never found that such benefits should go to anyone other than the Boston Gas customers. Yet, based on the Company's presentation, rather than decreasing, the A&G expense incurred by Boston Gas since Essex and Colonial mergers, and since the KeySpan merger, have increased by $20 million in excess of what can reasonably be explained by normal cost escalation over the last five years.

Q. What do you recommend?

A. I do not necessarily endorse the Company's interpretation of the orders in the Essex and Colonial merger cases regarding the allocation of non-incremental costs to

Boston Gas. However, even assuming that the Company's interpretation is correct, as I have for the purpose of my analysis, there should be certain adjustments to the Boston Gas cost of service.

First, unless the Company can demonstrate that the increase in A&G expenses since the period from before the merger is due to factors other than the way expenses are allocated among the affiliates, the Incremental Cost Adjustment should be reversed. The A&G allocated to Boston Gas even before the Incremental Cost Adjustment is already higher than it should it be based on the escalated level of A&G incurred by Boston Gas before the merger. To the extent that the Incremental Cost Adjustment increases the pro forma A&G expense included in the cost of service, it only serves to exacerbate this discrepancy.

Second, the A&G expense allocated to Essex should be increased, as the Company uses substantially the same method to determine the incremental expense attributable to Essex that it does for Colonial. Unfortunately, because the expenses deemed to be non-incremental to Essex are embedded in the Boston Gas costs, there is no separate identification of such costs. For the purpose of calculating the costs that should be re-allocated to Essex, I have assumed that the Colonial A&G expense prior to the Incremental Cost Adjustment, determined on a per customer basis, would be applicable to Essex. This results in a reduction of $1,816,000 in the A&G expense included in the pro forma cost of service (Schedule DJE-1, Page 3).

Q. Please summarize your proposed adjustment to pro forma test year operating expenses based on your review of the Incremental Cost Adjustment and the Boston Gas A&G expense.

A. To the extent that Incremental Cost Adjustment increases the pro forma A&G expense included in the Boston Gas cost of service, it should be reversed. This reduces pro forma test year expenses by $6,880,000. In addition, the A&G expense should be modified to reflect a re-allocation to Essex of the expenses treated as non-incremental by the Company. This reduces A&G expense included in the Boston Gas cost of service by $1,816,000. Thus, I am proposing a total reduction of $8,696,000 to pro forma A&G expense (Schedule DJE-1, Page 3). I would note that even after this reduction, the pro forma A&G expense included in the Boston Gas cost of service (excluding Accounts 922 and 926) is $44,925,000.[8] This is still well in excess of the expense calculated by escalating the pre-merger expenses to the 2002 test year.

IV. PENSION EXPENSE

Q. Is the Company proposing an adjustment to test year pension expense?

A. Yes. The Company is proposing to calculate its pro forma pension expense based on its average contribution to the pension fund for the years 2000 – 2002. The average contribution for this three-year period was $21,153,000. Net of the pension cost capitalized, the Company is proposing a pro forma pension expense of

[8] This excludes the effect of other pro-forma adjustments that would affect A&G expenses in addition to the Incremental Cost Adjustment. Such other adjustments include wages and salaries, incentive compensation, insurance, and the elimination of non-cost of service expenses.

$18,085,000. This is $11,855,000 greater than the pension expense actually booked by the Company in 2002.

Q. Is the Company's determination of pro forma pension expense reasonable?

A. No. In 2001, the contribution to the pension fund was $19,000,000. In 2002, the contribution to the pension fund was $44,460,000. This followed a period of four years of zero contributions to the pension fund. Clearly, the contributions in 2001 and 2002 included a catch up for the zero funding in the earlier years. While, it is true that the Company did include one of the zero years in its three-year average, the $21.1 million still appears to be well in excess of any reasonable estimate of the annual pension cost that the Company will incur on a normal, ongoing basis.

Q. Why do you believe that the estimate of $21.1 million annually is excessive?

A. First, it is well in excess of the historic level of cash contributions based on any average that goes back farther than the three ended in 2001. Further, in response to Information Request AG-11-13, the Company provided details of its estimated pension cost for 2003. That response shows an estimated pension cost of $17,366,000 for 2003, calculated pursuant to Statement of Financial Accounting Standards 87 ("SFAS 87"). However, even that estimate appears to be on the high side.

On Schedule DJE-2, Page 2, I show a comparison of the Company's estimated components of the SFAS 87 2003 pension cost, and an estimate of the SFAS 87 2003 pension cost based on the funded status of the pension plan at the end of 2002 as presented in the Boston Gas Company 2002 financial statements and the assumed discount rate and expected rate of return shown in the response to Information Request AG-11-13. While the revised estimate on Schedule DJE-2, Page 2 is greater than the periodic pension cost for 2002, it is less than the Company's estimate of $17,366,000.

Q. Please explain how you calculated the revised estimate on Schedule DJE-2, Page 2.

A. I used what I consider to be conservative assumptions in my estimate of the 2003 periodic pension cost pursuant to SFAS 87. I used the same forecast of the service cost and amortization of prior service cost as in the Company's estimate. I calculated the interest cost, which represents the annual accretion to the present discounted value of the benefit obligation, by applying the Company's assumed discount rate[9] to the benefit obligation at the end of 2002 plus one-half of the accrual for the 2003 service cost. I calculated the expected return on assets by applying the Company's assumed rate of return to the fair value of plan assets at the end of 2002 minus one-half the benefits paid from the fund.[10]

I used what I consider to be highly conservative assumptions in calculating the amortization of the unrecognized actuarial loss at the end of 2002. I assumed that the full amount of the unrecognized actuarial loss at the end of 2002 would be amortized over ten years. That is, I assumed no corridor adjustment[11] to the balance being amortized and I assumed an amortization period shorter than that

[9] Assuming semi-annual compounding

[10] Based on the benefits paid in 2002

[11] SFAS 87 permits an offset of up to 10% of the larger of the benefit obligation or the fund balance against the unrecognized actuarial gain or loss in determining the balance to be amortized in a given year.

permitted by SFAS 87. Based on the unrecognized actuarial loss at the end of 2001 and the actual amortization recorded by the Company in 2002, the actual amortization of the unrecognized actuarial loss in 2003 will probably be less than I have reflected on my Schedule DJE-2, Page 2.

Q. What is the estimated periodic pension cost for 2003 that you have calculated?

A. I have calculated a periodic pension cost of $12,581,000 for 2003. This is $4,785,000 less than periodic pension cost pursuant to SFAS 87 estimated by the Company.

Q. How do you recommend that the pro forma pension expense be calculated?

A. I recommend that the average cash contribution to the pension plan for the five-year period 1998 –2002 be used to determine the pro forma pension expense. As the contributions in 1998 and 1999 were also zero, using a five-year average would spread the contributions in 2001 and 2002 over five years rather than the three years proposed by the Company. This would mitigate the effect of catch-up contributions made in 2001 and 2002. Although the contribution in 1997 was also zero, I believe that use of a five-year average is reasonable in the circumstances.

In addition, use of a five-year average of cash contributions to the pension plan is consistent with the method of calculating pension expense approved by the Department in D.P.U. 96-50. The Company has provided no compelling reason why the practice of using a five-year average, as previously approved by the Department, should be changed at this time. Finally, the five-year average of cash contributions to the pension plan approximates the estimated periodic pension cost for 2003 pursuant to SFAS 87, as I have calculated it above. This should minimize the difference between the pension expense recovered in rates and the pension expense recorded by the Company on its books, which reflect generally accepted accounting principles.

Q. What is the effect of using the average cash contribution for the five-year period 1998 –2002 to determine the pro forma pension expense?

A. The average cash contribution for the five-year period 1998-2002 was $12,692,000 (Schedule DJE-2, Page 1). Applying the Company's operation and maintenance expense ratio of 85.50% to determine the amount charged to expense, the pro forma pension expense is $10,851,000. This is $7,234,000 less than the pro forma pension expense calculated by the Company.

V. PENSION/PBOP RECONCILIATION ADJUSTMENT CLAUSE

Q. Please describe the Pension/PBOP Reconciliation Adjustment Clause ("reconciliation mechanism") proposed by Boston Gas.

A. The proposed reconciliation mechanism entails an annual surcharge to the Company's base rates. It would reconcile the actual pension expense recorded by the Company pursuant to SFAS 87 to the pension expense included in rates as a result of this proceeding. Any difference would then be collected from or refunded to customers with carrying charges on the cumulative balance of any over or under recovery. In addition, the mechanism would include carrying charges, at the overall authorized rate of return, on the prepaid pension balance carried on the Company's balance sheet.

Q. Has Boston Gas established that the proposed reconciliation mechanism is a necessary and appropriate mechanism to implement at this time?

A. No. As a general matter, reconciliation mechanisms are contrary to sound ratemaking practices, as such mechanisms tend to either reduce or eliminate incentives to control costs. The Company presents its proposal as a reconciling mechanism that would address the volatility of pension costs and mitigate potential financial impairment resulting from such volatility. However, the Company has not provided any measurement of the volatility of pension costs or any measurement of how the magnitude of changes in pension costs relate to its overall revenue requirements; nor has the Company compared the magnitude or volatility of pension costs relative to other costs for which there is no adjustment mechanism.

Q. Has the Company presented any data or analyses that establish the potential for the volatility of the pension expense to impair its financial integrity?

A. No. Pension expense is accrued by the Company pursuant to relevant financial accounting standards, which require certain actuarial and financial assumptions. While it is true that changes in those assumptions or changes in the funded status of the plan can cause pension expenses to fluctuate, just about all other expenses included in the Company's base rate cost of service are also subject to fluctuation. The Company has not explained why pension costs should be treated differently from these other expenses that go into the base rate revenue requirement. Further, the Company has not presented any analysis showing that the fluctuations in pension costs are of such a magnitude that they have the potential to impair its financial integrity.

Q. If the Company could demonstrate that the fluctuations in the pension costs pose a significant financial risk, then is its proposal complete?

A. No. The Company does not presently have a pension reconciliation mechanism in place. Thus, to the extent the volatility of pension expense causes financial risks, such risks are implicitly incorporated into the cost of common equity. If a reconciliation mechanism is approved, then such financial risks are transferred to the Company's customers. If the financial risks are transferred, then the common equity investment is less risky, and the authorized return on common equity should be reduced to incorporate the reduced level of risk. It would be inappropriate to incorporate the proposed reconciliation mechanism without an adjustment to the cost of service to recognize the effect of the reduced riskiness of the Company's common equity.

Q. Is approval of the proposed reconciliation mechanism necessary to avoid a charge to equity, through other comprehensive income, to recognize an "Additional Minimum Liability"?

A. No. To my knowledge, the Department has always permitted recovery of reasonable and prudent pension expense through the cost of service. Thus, to the extent that the Company's pension costs are reasonable and prudent, there is reasonable assurance that the Department will establish rates that are adequate to generate revenues that will recover those costs. Accordingly, pursuant to Statement of Financial Accounting Standards No. 71, Paragraph 9, the Company can book a regulatory asset to offset the Additional Minimum Liability, even in the absence of a reconciliation mechanism, and should not have to write off the prepaid pension asset.[12]

Q. Is the Company's proposal to recover carrying charges, at the overall authorized rate of return, on the prepaid pension balance carried on the Company's balance sheet appropriate?

A. No. It is my understanding that it has not been the general practice of the Department to include prepaid pension balances, to the extent such balances relate to differences between the pension cost pursuant to SFAS 87 and cash contributions to the pension plan, in utility companies' rate bases. In effect then, allowing recovery of carrying charges on the prepaid pension balance in the reconciliation mechanism would allow the Company to recover through a surcharge to base rates that for which the Department has denied recovery in the base rate revenue requirement.

Further, the prepaid pension balance reflects the difference between the pension cost pursuant to SFAS 87 and cash contributions to the pension plan, not the difference between the pension expense recovered in rates and cash

12 Obviously, if any of the costs were found to be unreasonable or imprudent, then they would not be recoverable; in that hypothetical circumstance no regulatory asset would be appropriate for the unreasonable or imprudent costs.

contributions to the pension plan. Therefore, the prepaid pension cost on the Company's balance sheet is not a measure of the cash required by investors to cover the difference between the actual recovery of pension expense in rates and cash disbursements to the pension plan.

Finally, the notes to the Company's financial statements, the same financial statements from which the $54,582,000 of prepaid pension cost was taken, indicate that there was a net liability of $52,355,000 for accrued PBOP cost as of the end of 2002. It would be inconsistent to recover a return on the prepaid pension cost without any offset for the accrued PBOP liability.

VI. INCOME TAX CALCUATION

Q. Are you proposing an adjustment to the Company's income tax calculation?

A. Yes. In the 2002 test year, the Company recorded $842,000 of investment tax credit amortization. The calculation of income tax expense on Exhibit KEDNE/PJM-2, Page 35 does not reflect that amortization of investment tax credits. It should. Inclusion of the investment tax credit amortization in the income tax calculation reduces the pro forma income tax expense by $842,000 and the revenue requirement by $1,385,000.

Q. Does this conclude your direct testimony?

A. Yes.